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Article

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The Quality of Disclosure under IAS 38 in Financial Statements of Entities Listed on PSE

*Michal Novák**

Abstract:

There has been no recent examination of a disclosure of intangible assets under IFRS of entities listed on PSE. Hence, this article focuses on such an examination within financial statements reported for 2015 by entities listed on PSE and investigates whether these reports meet the minimum informational IFRS requirements. Adopted was the content analysis method, using a scoring system for the set of four questions which were answered (88 observations). The results revealed a poor level of the disclosure quality within the sample. Furthermore, our findings exposed a better level of disclosure for manufacturing companies relative to service companies, implicating a close linkage of disclosure compliance and the associated industry sector.

Key words: IAS 38; Intangible Assets; IFRS; Disclosure.

JEL classification: M40.

1 Introduction

The information (“lemons”) problem arises from information differences and conflicting incentives between business units and their investors (savers), which can lead to an operational breakdown of the capital market (Akerlof, 1970). The consequences of failing to satisfy the investors’ needs include potential inability to increase and allocate capital efficiently (Jenkins, 1994, p. 77). The problem with the traditional financial accounting framework is that the reporting lacks the recognition of an intangible value and creates an information gap between insiders and outsiders (Vergauwen et al., 2007). Consequently, IFRS setters and regulators justify the reporting and disclosure requirements at the request of investors for decision-useful information (O’Connell, 2007, p. 217). Financial reporting and disclosure are potentially significant tools of the management to communicate the performance of their entity to prospective investors (Healy and Palepu, 2001).

There is a considerable pressure on entities to report and state the true, fair and complete information on assets and liabilities under management in their financial

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statements. With reference to the different typology of disclosures, it is possible to identify (Graham et al., 2005):

- mandatory disclosure (see IAS 38 in paragraphs 118-128), and
- voluntary disclosure (not specifically required).

Disclosure regulation is motivated by concerns other than market failures. For example, regulators might be concerned about the welfare of financially unsophisticated investors. By creating and imposing the minimum mandatory disclosure requirements, the information gap between informed and uninformed investors is reduced. Furthermore, abstracting from market imperfections or externalities, entities have incentives to optimally trade off the costs and benefits of voluntary disclosure and to produce the efficient level of information for investors in the economy (Healy and Palepu, 2001, pp. 411-412).

The value of mandatory disclosure requirements cannot be properly assessed without understanding what, if any, voluntary disclosures might be made in addition to the mandatory disclosures (Einhorn, 2005, p. 613). Hence, this paper focuses both on the mandatory and voluntary disclosures.

The goal of this paper is to scrutinize annual financial statements of entities listed on the Prague Stock Exchange (hereinafter referred to as “PSE”) whether they meet the minimum informational IFRS requirements.

2 Literature Review

Skinner (2008) proclaimed in his study that mandating additional disclosures in the case of intangible recognition is unlikely to be successful and that proposals to recognize intangibles are also flawed. In short, there is no additional value that is provided to the investors and they need to rely on their incentives. Co-authors, Teodori and Veneziani, and another author, Dumitrescu, came to the similar conclusion like Skinner. Teodori and Veneziani (2010) state that not only is there little voluntary information, but from time to time there is also little mandatory information, which would address the most delicate aspect introduced by IAS 38. Dumitrescu (2012) developed a disclosure standard based on the most important intangible assets mentioned in the literature: the human capital, technology, customers, quality policy and image. His study showed that firms do not attach enough importance to the disclosure of detailed information on intangible assets in their annual financial reports.

Fadur et al. (2013) identified the extent to which companies listed on the Bucharest Stock Exchange and the Madrid Stock Exchange comply with the disclosure requirements under IAS 38. There were analysed consolidated financial statements under IFRS. Based on the set of eight questions proposed by the

authors in harmony with the IFRS requirements, the level of disclosure in Romanian firms is much lower than that in Spanish firms. Besides, it is worth noting that unlike Romanian firms, Spanish firms report a large amount of information on intangible assets. It is proved that reporting quality depends on the national legal system and its enforcement mechanisms (Miková, 2014, p. 15).

Another article from Devalle and Rizzato (2013, p. 3) shows that even if information required by IFRS 3 and IAS 36 is mandatory, not all the groups disclosed the items as required by IFRS. They divided their sample into industrial firms and financial firms. They concluded that results are more consistent among industrial firms compared to financial firms. Higher market capitalization, leverage, revenues, and ROS all have a relevant impact on the higher level of compliance of the group to disclose mandatory information.

Recently we may also take note that many articles focus on testing the disclosure IFRS requirements of entities listed on PSE.

Čevela examined the disclosed information obligation of firms on PSE within annual financial statements under the Czech regulations and IFRS. His study demonstrated a high level of compliance of the firms listed on PSE, supporting the notion that the disclosure quality can be strongly influenced by country-specific and local factors. (Čevela, 2016)

Revenue is considered to be one of the most important indicators for investors and other users of financial reports. Knorová focused on reviewing the disclosure requirements and whether the Czech firms report revenues in compliance with IFRS 15 and IAS 18. Her study revealed significant differences in the quality of revenue disclosure beyond the mandatory obligations under IAS 18. The main distinctions among the reviewed companies lie in the detailed structure of revenue disclosed and the extensiveness of the disclosed accounting revenue policies. (Knorová, 2016)

Business combinations raised new requirements for disclosed information on goodwill impairment and debate on the importance of goodwill as an asset. Boučková examined the disclosed information on goodwill impairment in consolidated financial statements under IFRS. Her study reveals that the mandatory disclosure under IAS 36 is very low. Only 18 % firms from her sample disclosed the mandatory information on goodwill impairment and half of the firms wrote off goodwill and reported mandatory information on impairment loss. Specifically this type of information forms the basis for a future decision-making of the potential investors considering their investment in the particular company's stock. (Boučková, 2016)

Aggregating financial information for all the joint ventures or associates would not result in a useful information under IAS 31 and IAS 28, when the entity holds a different percentage of ownership interests in its joint ventures or associates. Users of financial statements requested a more detailed disclosure of joint ventures. IASB thus responded by including additional disclosure requirements on joint ventures and associates in the new standard IFRS 12 – Disclosure of interests in other entities. Ašenbrennerová investigated whether entities disclose all the requirements under IFRS 12, especially the newly required summarised financial information on joint ventures and associates. The empirical study is focused on the first year following the implementation of IFRS 12, which should be applied since 2014. Her study indicates that more than half of the reviewed entities did not disclose information in harmony with IFRS 12. The majority disclosed information only on total assets, total liabilities, expenses, revenue and profit. (Ašenbrennerová, 2016)

Presented articles clearly demonstrate the significance of disclosure both from the firms' and investors' perspectives. There is still a significant research gap that encompasses systematic examination of a low compliance with IFRS. The presented article should therefore contribute towards bridging the gap in recent studies, aiming specifically at the disclosure of entities listed on PSE and adopting the content analysis using a scoring system.

This article focuses on examination of disclosed information on intangible assets since the importance of intangible assets is presently rather obvious. For some firms, intangibles are the engine behind their business. As a good example may serve the Walt Disney Company. Nobody else can legally manufacture and sell the thousands of original characters and stories under its ownership. On its balance sheet, Disney carries shy of USD 35¹ billion as of October 3, 2015 of intangible assets (The Walt Disney Company, 2018) and goodwill, though this is certainly worth more.

The goal of this paper is to study the annual financial statements filed for 2015 by the entities listed on PSE and to find out whether the disclosure of information on intangible assets meets the minimum informational criteria imposed by IAS 38. Note that this paper does not deal with a disclosure of goodwill. The minimum informational criteria relate to information included in the explanatory notes to the financial statements and inclusion of principal elements related to intangible assets. This research is trying to fill the gap in recent Czech articles.

¹ USD 7.2 billion out of USD 35 are intangible assets, the rest of it is goodwill.

3 Data and Methodology

In order to achieve the above stated goal, I have built a set of four questions. It should be noted that that these questions² (see below) originally came from the article by Fadur et al. (2013).

- Q1: Does the company distinguish internally generated intangible assets from the acquired intangibles?
- Q2: Does the company mention whether the useful lives are specified? If so, does the company describe the determinants that played a decisive role to be capable of estimating the lifetime?
- Q3: Does the company show the movements, rises and reductions in its report and provide thorough explanation of the dynamics of intangibles?
- Q4: Does the company indicate the impairment adjustments accompanied by a short justification for the corresponding causations?

Each answer will be subsequently noted with points from 0 to 4. Four represents a satisfying, complete and detailed answer. The criteria are presented in Table 1.

Tab. 1 Evaluation criteria

Points granted	Criteria	Description
0	No answer	There is no mention of anything at all.
1	Vague answer	The financial statement report contains only references to key words of the particular question related to the financial statement and as such it lacks the precision or detail.
2	Partial answer	Users of the data in the economy cannot make rational and optimal decisions based on a partial ³ answer in financial statements.

² Over the course of writing this article, I found out that my initial questions were consistent with the research questions of Fadur et al. (2013). Some may consider the presented paper as a mere replication of the above-mentioned research within the Czech conditions. However, the original questions were simply defined and asked. Therefore, I preserved the source questions in my article to a certain extent. An alternative view might be that similar topics call for questions that are – accordingly – formulated similarly, if not identically.

³ For example: the financial statement report contains a useful life for each of the individually listed intangible assets whereas there is no mention of the factors impacting the useful life and hence the partial answer. The movements, rises and reductions of intangible assets are represented in the table without any additional information in notes and hence the partial answer. When financial statements contain impairment adjustments without any explanation of the corresponding causes, there is recorded a partial answer.

Points granted	Criteria	Description
3	Detailed but incomplete answer	Explanatory factors are incomplete or additional information provided barely support the partial answer.
4	Complete and detailed answer	It provides detailed information needed for rational decision-making.

Source: Authorial computation.

3.1 Sample selection

The empirical study focuses only on the disclosure and notes under IAS 38.

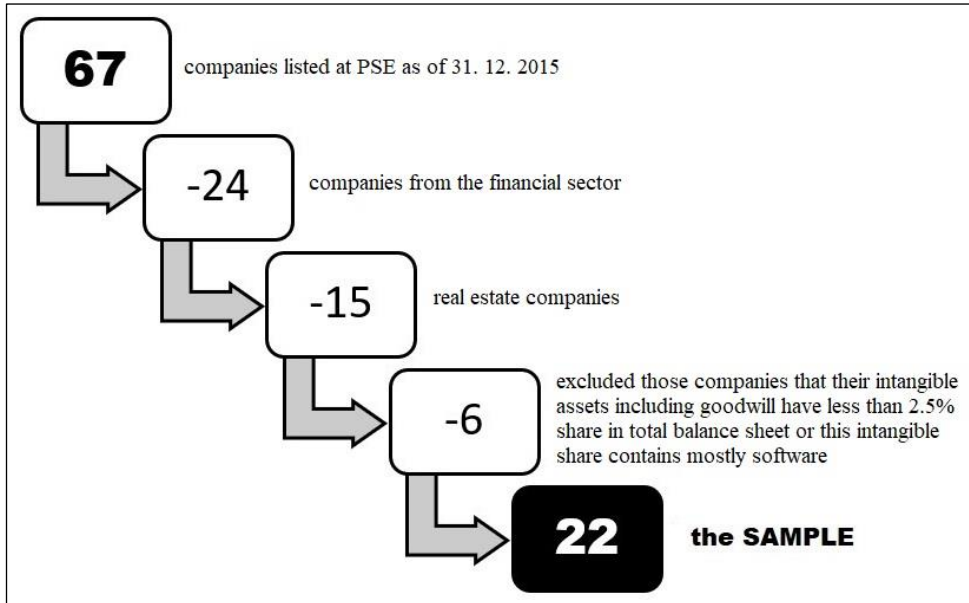
To begin with, I have specified a set of entities that would be eventually assessed. According to the Section 19a of Act No. 563/1991 Coll., on accounting, firms that issue marketable securities (bonds or shares) on the European regulated market are obliged to compile their financial statements in compliance with IFRS. For that purpose, the official register administered by the Czech National Bank (ČNB, 2018) was used. As a result, I ended up with 67 entities listed on PSE as of December 31, 2015.

Of these 67 firms,

- 24 are from the financial sector (banks and insurance companies);
- 15 are from the manufacturing industry (beer, chemical, engineering, textile, and energy industry, etc.);
- 12 are real estate companies;
- 11 firms provide services (media, advertising, telecommunication, asset management, projecting, etc.);
- 3 are transport companies (air and railway services);
- one is a software company, and
- one deals with transit of gas.

In order to arrive at meaningful results, the following companies had to be excluded from the list of 67 entities. This narrowed the list to 22 firms.

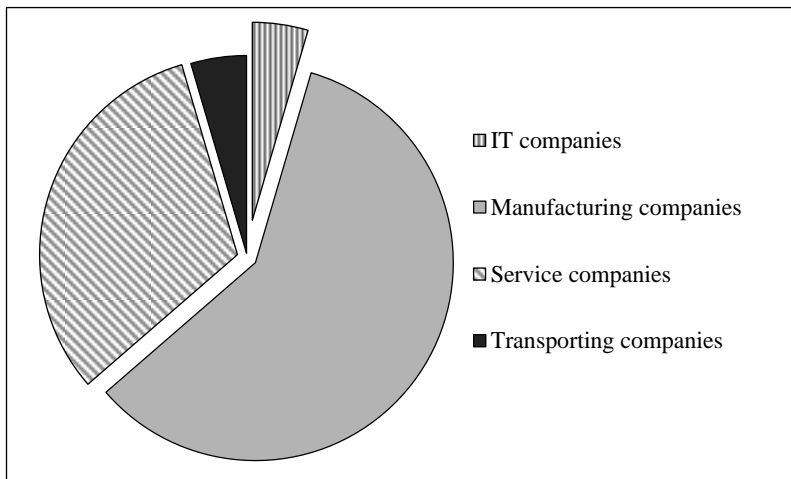
Fig. 1 Sample selection



Source: Authorial processing.

All these entities are subject to the IFRS reporting. The sample contains 13 companies from the manufacturing industry, 7 companies providing services, one software company, and one transport company that provides railway services (see Figure 2). Our sample serves as a good example of the importance of intangible assets with, on average, 33.8% proportion of the intangible assets including goodwill on the sample's total balance sheet. Only four companies possess intangibles whose proportion exceeds 50% of the total balance sheet.

Fig. 2: Industrial structure of the sample

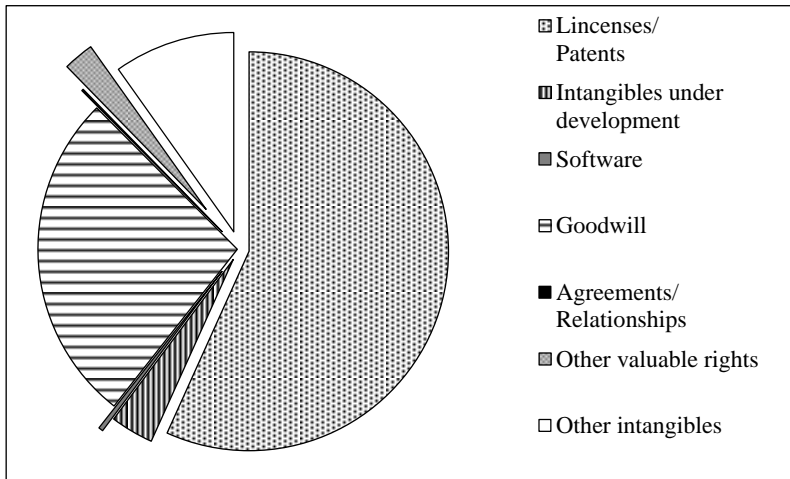


Source: Authorial computation.

Figure 3 displays the structure⁴ of intangibles. The main class of intangibles comprises licenses and patents (such as broadcast licenses, patents, emission allowances, licenses of frequency bands, etc.). The second category represents goodwill. The third one includes other intangibles (not specified in financial statements). The last four classes are Intangibles under development, Other valuable rights (mostly trademarks and collections of brands), Software, and Agreements (such as tenancy agreements, customer relationships, customer base, and other agreements or contracts).

⁴ A class of intangible assets is a grouping of assets of a similar nature and use in an entity's operations – see classes of intangible assets in IAS 38 in the paragraph 119. The classes mentioned in this paper are aggregated into larger classes. This structure of intangibles provides more relevant information and is based on the analyzed financial statements.

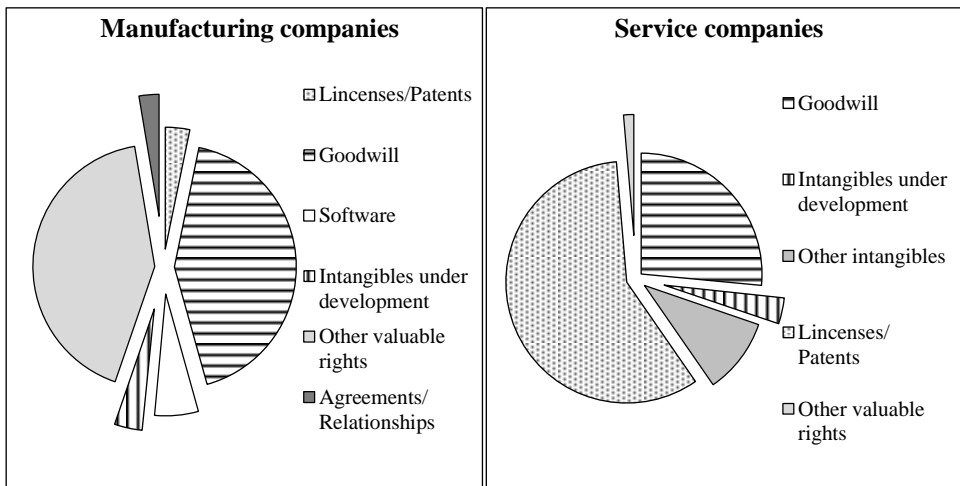
Fig. 3: Structure of intangible assets of the sample



Source: Authorial computation.

Our sample is predominantly comprised of two types of companies oriented on manufacturing or services. As we can see in Figure 4, the structure of intangibles in these two types of companies differs widely. Licenses, tenancy agreements, customer base, trademarks, etc. have circa 60% proportion of intangible assets in service companies whereas trademarks (circa 45 %) and goodwill (circa 42 %) have the highest proportion of intangible assets in manufacturing companies.

Fig. 4: Structure of intangible assets in manufacturing vs. service companies



Source: Authorial computation.

3.2 Results

Four questions (see Chapter 3) were answered for all the 22 financial statements of entities listed on PSE, hence there are in total 88 observations.

Q1: Does the company distinguish internally generated intangible assets from the acquired intangibles?

An entity must make the distinction between internally generated intangible assets and other intangible assets in accordance with IAS 38 – Intangible assets. For the sample, 82 % of the listed companies do not present this delimitation in their financial reports. In the table below, we can see the result of this question.

Tab. 2 The result of Q1

Points granted	Criteria	Answers	Significance (in %)
0	No answer	18	82
1	General answer	0	0
2	Partial answer	1	5
3	Detailed but incomplete answer	0	0
4	Complete and detailed answer	3	14

Source: Authorial computation.

In our case, Deutsche Telekom, New World Resources PLC, and Unipetrol make a sharp distinction between the intangible assets acquired (68 %), those internally generated (3 %), goodwill (26 %), and intangibles under development (4 %). Only one company in its disclosure partially reported information on some intangibles acquired. In conclusion, there is a need to check companies whether they draw a distinction between intangibles acquired and those internally generated in their financial reports under IFRS.

Q2: Does the company mention whether the useful lives are specified? If so, does the company describe the determinants that played a decisive role to be capable of estimating the lifetime?

Tab. 3 The result of Q2

Points granted	Criteria	Answers	Significance (in %)
0	No answer	4	18
1	General answer	8	36
2	Partial answer	8	36
3	Detailed but incomplete answer	1	5
4	Complete and detailed answer	1	5

Source: Authorial computation.

One company provided a complete and detailed answer and another gave a detailed answer. Description of the factors remains incomplete. 36 % of companies from the sample reported only general information on useful lives of their intangible and tangible assets (for example, the number of years for each class of intangibles), which corresponds to the third criterion labelled as “Partial answer”. 36 % of companies provided a general answer of the useful life of intangible assets as a whole (for example, general information on amortisation, no amortisation years for intangibles) and 18 % of the companies did not report anything at all.

Q3: Does the company show the movements, rises and reductions in its report and provide thorough explanation of the dynamics of intangibles?

Tab. 4 The result of Q3

Points granted	Criteria	Answers	Significance (in %)	
0	No answer	0	0	0
1	General answer	0	0	0
2	Partial answer	10	46	
3	Detailed but incomplete answer	6	27	
4	Complete and detailed answer	6	27	

Source: Authorial computation.

All the companies presented the movements, rises and reductions in their financial statements for 2015. Only 55 % of the companies provided detailed or complete information explaining the dynamics of intangibles.

Q4: Does the company indicate the impairment adjustments accompanied by a short justification for the corresponding causations?

Tab. 5 The result of Q4

Points granted	Criteria	Answers	Significance (in %)	
0	No answer	11	50	
1	General answer	2	9	
2	Partial answer	3	14	
3	Detailed but incomplete answer	2	9	
4	Complete and detailed answer	4	18	

Source: Authorial computation.

Fifty per cent of the companies fail to explain the corresponding causes of the impairment adjustments. Moreover, 23 % of the companies offer only general or partial explanation, which is not relevant to the third parties. Only six companies out of 22, approximately 27 %, presented detailed and complete information.

4 Conclusion

The presented paper aims to examine the disclosure of intangible assets under IAS 38 related to the entities listed on PSE. Within the first section, there was an effort to point out the disclosure asymmetry. In the second part, the theoretical basis of the issue was explained along with some key references to the published articles. To date, only the paper by Boučková (2016) was published on a similar topic – Goodwill. Other papers were focused on IFRS mandatory disclosures, apart from the disclosure under IAS 38. As a follow-up to the published papers and as a reaction to the research gap, the research section focused on the disclosed information related to intangible assets in annual financial statements of entities listed on PSE in accordance with the requirements of IAS 38. The result revealed a poor level of disclosure of intangible assets in financial statements filed by the analysed companies listed on PSE. Additionally, Glaum et al. (2013) arrived at a conclusion that compliance is closely linked to industry, which is consistent with our findings that the highest compliance score was achieved by manufacturing companies.

First of all, this study is limited to the entities listed on PSE. Secondly, similar research within other European countries might bring different results. Besides, the article deals with the particular IFRS disclosure requirements (IAS 38).

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